United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

76-7067

To be argued by
ALFRED S. JULIEN

B

P/S

In The

United States Court of Appeals

For The Second Circuit

UNITED STATES FIDELITY & GUARANTY COMPANY,

Plaintiff-Appellant,

vs.

ROYAL NATIONAL BANK OF NEW YORK and MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York (C.D. 68 Civ. 2054 (H.F.W.))

REPLY BRIEF FOR PLAINTIFF-APPELLANT

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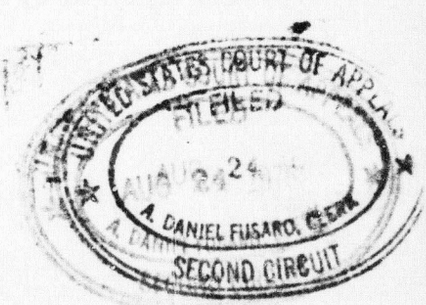

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

----------X

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Introductory Statement

The plaintiff, United States Fidelity & Guaranty Company ("USF&G"), is submitting this brief in reply to the arguments raised by the defendants-appellees on this appeal.

POINT I

THE POSITION TAKEN BY THE DEFENDANT BANK THAT IT WAS SIMPLY ACTING AS AN AGENT FOR MAZZOCHI AND THE POSITION TAKEN BY MERRILL LYNCH THAT THE BANK WAS ITS CUSTOMER, DIRECTLY CONTRADICT EACH OTHER.

The facts of this case are set forth at lenghth in the appellant's initial brief. However, in short, this case concerns $212,000 in United States Treasury Notes, which were stolen from the plaintiff's assignor. One

Frank Mazzochi, Jr. was convicted of criminally concealing and withholding stolen property with regard to these Notes. Between August 5th and September 12, 1966, Mazzochi sold all of these Notes to the Royal National Bank of New York (the "Bank"). These Notes were sold by the Bank to Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch").

As is pointed out in the plaintiff's brief, the circumstances under which the Bank purchased these Notes from Frank Mazzochi, Jr. ("Mazzochi") were highly suspicious and required the Bank to investigate whether or not Mazzochi had a right to sell the Notes in question. The suspicious circumstances were such that the failure of the Bank to ascertain Mazzochi's right to possess the Treasure Notes constituted precisely the kind of "disregard of suspicious circumstances" which evidenced bad faith so as to make the Bank liable for conversion even under the strict test laid out in Gutekunst v. Continental Insurance Company, 486 F.2d 194, 195 (2d. Cir. 1973) and to make Merrill Lynch likewise likewise liable for conversion.

On this appeal as well as in the Court below, the Bank argues that it is not liable by virtue of UCC 8-318 which provides in essence that an agent who observes reasonable commercial standards is not liable for conversion al-

though his principal has no right to dispose of the securities in question. The Bank repeatedly on this appeal takes the position that it was simply acting as a agent for Mazzochi and not as a principal in the sale of the stolen Treasury Notes (Bank's brief, pages, 8, 23 and 24). The Bank also points to the fact that each of the transmittal slips, whereby it sent the securities to Merrill Lynch, was clearly labelled "For the Account of: Frank Mazzochi, Jr." (JA 13, 638-641).*

Merrill Lynch in its brief to this Court (Merrill Lynch's brief, pages 2-3) as well as the Court below consistently takes the position that the Bank was not acting as an agent for Mazzochi in its dealings with Merrill Lynch, but rather that the Bank was Merrill Lynch's customer and Merrill Lynch had no duty to discover who Mazzochi was although admittedly each of the transmittal slips clearly indicate that the transactions were for the account of Mazzochi (JA 13, 638-641) and Merrill Lynch was aware that transactions for the Bank's account originated out of the Bank's main office and not through its branch in the Bronx (JA 202-205).

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* All page references are to the appendix unless otherwise indicated.

If Mazzochi is found to have been Merrill Lynch's customer, then Merrill Lynch is clearly liable to the plaintiff for conversion since it obviously failed to comply with Rule 405 of the Rules of the New York Stock Exchange which requires that every member firm of the Stock Exchange use due diligence to learn the essential facts relevant to every customer and every order which it executes. The failure to comply with Rule 405 is construed by law as lack of good faith on the part of a brokerage firm, thus not giving the brokerage firm the benefit of UCC 8-318 and/or UCC 8-304 and the brokerage firm would be liable for conversion if it took possession of securities which had been stolen (See Hartford Accident & Indemnity Company v. Walston & Co., 21 N.Y.2d 219, 287 N.Y.S.2d 58 (1967).

Admittedly, Merrill Lynch had no knowledge at all as to who Mazzochi was and how he came into the possession of the stolen Treasury Notes.

It is this logical impossibility of the Bank at the same time being simply Mazzochi's agent and yet to permit Merrill Lynch to maintain the position that it is the Bank rather than Mazzochi who was its customer which has led the defendants to quarrel among themselves and adopt

the directly contradictoty positions which they have done on this appeal. Despite this logical inconsistency of the Bank being exculpated by UCC 8-318 because allegedly it acted in good faith simply as an agent and at the same time it was the Bank who was Merrill Lynch's customer and not Mazzochi, the District Court below nevertheless found that the Bank did have these chameleon-like qualities in finding that the Bank had acted simply as an agent in good faith and at the same time Merrill Lynch had not violated the "no your" customer rule (Rule 405) of the New York Stock Exchange (JA 17). The Court below dismissed the New York Court of Appeals case of Hartford Accident & Indemnity Company v. Walston, supra with the simple statement that it "is inapposite."

The plaintiff admits that the Bank cannot be both an agent and a principal at the same time for the purpose of the very same transaction. If, in fact, Merrill Lynch is correct and the Bank acted as a principal, then the Bank is liable for conversion to the plaintiff since it no longer has the protection of UCC 8-318, which is made applicable only to agents. On the other hand, if the Bank is correct and it acted simply as an agent, then Merrill Lynch is liable for conversion because it failed to follow reasonable commercial standards by disobeying Rule 405 which required it to have

knowledge as to who Mazzochi was before purchasing $212,000 worth of Treasury Notes from him.

As has been pointed out in the appellant's main brief (page 37) even if we assume that the Bank was Merrill Lynch's customer, Merrill Lynch and the Bank would both be liable to the plaintiff since Rule 405 requires that a brokerage firm be familiar with the essential facts not only with regard as to its customers, but also with regard as to "every order." There can be no question that Merrill Lynch was aware that the orders for the sale of the Treasury Notes were for the account of Mazzochi since each transmittal clearly stated that information.

Having made no effort to determine the essential facts with regard to the order for the sale of the Treasury Notes, even if the Bank is found to be Merrill Lynch's customer, Merrill Lynch is still liable to the plaintiff for failing to follow reasonable commercial standards and negating the good faith defense otherwise made available to it by UCC 8-318.

POINT II

THE CIRCUMSTANCES UNDER WHICH THE BANK ACCEPTED $212,000 IN TREASURY NOTES WERE HIGHLY SUSPICIOUS IN THE BANK'S FAILURE TO CONDUCT ANY INVESTIGATION AS TO MAZZOCHI'S RIGHT TO THE TREASURY NOTES AND CONSTITUTES BAD FAITH AND MAKES THE BANK LIABLE FOR CONVERSION.

The Bank, being unable to deny the basic fact that it accepted $212,000 in Treasury Notes from Mazzochi whom it knew nothing about except that he was the President of small mutual credit union having an average balance of approximately $1000 (JA 248-862, 941), has resorted in its brief, to the tactic of rather than attempting to advise the Court as to what facts it did have as to Mazzochi to justify these transactions with them to instead setting forth a list of persons in the neighborhood who were members of the Mutual Credit Union with [illegible]dible recommendations in an attempt somehow to make it appear that Mazzochi was a member of this group rather than a person whom the Bank knew nothing or little about (Bank's brief, pages 4-5).

The Bank's conduct becomes even more flagrant in light of the requirement that each bank maintains credit information sufficient to show it had exercised prudence in making its determinations (See Comptrollers Manual for National Banks, Regulations of the Comptroller of the Currency, Sections 1.3, 1.4 and 1.8).

When Mazzochi brought in the last $72,000 in Treasury Notes on September 12, 1966, even the Bank could no longer ignore the red flags raised by the manner in which Mazzochi was conducting his transactions. Accordingly, one of the

Bank's officers, McGraw, ordered the money to be held in a suspense account (JA 779,693). The Bank later released this money to Mazzochi without having received any proof from Mazzochi that he owned the Treasury Notes, except for a self-serving affidavit from Mazzochi that the Notes belonged to him (JA 976-977).

The Bank, in its brief, in an attempt to make this totally unacceptable behavior by the Bank seem proper, has related the incident in a way so as to make it appear that the Bank conducted an extensive investigation with regard to Mazzochi from the very first and had followed proper procedures in dealing with Mazzochi (Bank's brief, pages 9-12).

Despite the Bank's attempt to cast its actions in favorable light, the Bank is compelled to admit that McGraw, the Bank officer who knew Mazzochi for two years on a first-name basis, had become so suspicious of Mazzochi's transactions that he placed the funds in a suspension account (Bank's brief, page 9). It is astounding to have the Bank claim in its brief (page 20) that McGraw was not suspicious of Mazzochi's transactions, but had placed the proceeds of the Treasury Notes in a suspense account simply because he was concerned about the possible violation of

the Federal Reserve Bank regulations. Any such testimony is incredible on its face.

It is apparent that by the time this September 12, 1966 transaction took place of the last $72,000 in Treasury Notes, even the Bank had become convinced that Mazzochi had no right to the Notes. On September 21, 1966, Hoffman, an Assistant Vice President, wrote a letter to the Federal Reserve Bank reporting unusual cash transactions on the part of Mazzochi (JA 647). In fact, the Bank had been required to file a report on these unusual cash transactions by federal treasury regulations no later than September 15, 1966, but had failed to do so (JA 649-651). There is absolutely no basis at all by which the Bank can justify accepting $212,000 in Treasury Notes from Mazzochi. The cases cited by the Bank in its brief in support of its position are all inapposite.

Whenever one deals with a question as to whether or not the Bank acted in good faith or whether it failed to conduct an investigation in light of highly suspicious circumstances, the critical fact is the specific facts of the case in question. Thus, the cases relied upon by the Bank in its brief are totally inapposite. In Fidelity and Casualty Company of New York v. Key Biscayne Bank, 501 F.2d 1322 (5th Cir. 1974).

the Bank did a complete investigation and had the IBM shares which were deposited as security actually transferred to the depositor's name. The transfer agent had no knowledge that they were stolen and the Bank had, thus, acted in good faith. Similarly, in Manufacturers and Traders Trust Company v. Murphy, 369 F.Supp. 11, 13 (W.D. Pa. 1974), the Bank verified the fact that there was sufficient funds on account prior to cashing the check and likewise acted in good faith. In Colin v. Central Penn National Bank, 404 F.Supp 638 (E.D. Pa. 1975), the Bank did a complete investigation on the depositor, but failed to uncover a fraudulent scheme. The Bank there too had acted in good faith. In all of those cases there were no suspicious circumstances and the Bank had acted in a proper fashion. In our case a mere recital of the circumstances is sufficient to show their suspicious nature and there can be no question that under these circumstances the Bank was required to determine where Mazzochi had obtained the Treasury Notes in question.

The principal case relied upon by the defendants and the Court below is Gutekunst v. Continental Insurance Company, 486 F.2d 194 (2d Cir. 1973).

In Gutenkunst this Court had found that where

there were no suspicious circumstances the Bank did not have a duty to investigate a customer whom it did not know. The Court in Gutekunst, however, was careful to find that where there were suspicious circumstances, the Bank would have a duty to investigate since the disregard of suspicious circumstances may constitute bad faith. 486 F.2d at 195.

Gutenkunst did not stand for the proposition that the Bank may disregard suspicious circumstances and still be found to have acted in good faith. In our case the failure to investigate in light of all the available suspicious circumstances constituted bad faith on the part of the Bank.

POINT III

THE PLAINTIFF IS NOT EQUITABLY ESTOPPED FROM RECOVERING FROM THE DEFENDANTS.

The Court below and the defendants on this appeal make reference to the case of Bunge Corporation v. Manufacturers Hanover Trust Company, 31 N.Y.2d 223, 228, 335 N.Y.S.2d 412, 415 (1972) for the proposition that the plaintiff is somehow equitably estopped from recovering from the defendants because the plaintiff knew of the loss of the Treasury Notes on September 24, 1966 and the last $72,000 in treasury notes were not released from the suspense account until September 29, 1966 (JA 17-18).

Even if the principle of equitable estoppel did apply, it would only be with respect to the final $72,000 and not to the first $140,000. However, the law is clear and has recently been restated by the First Circuit in Morgan Guaranty Trust Co. v. Third National Bank, 529 F.2d 1141, 1144 (1st Cir. 1976), that equitable estoppel does not act as a bar where it is not the plaintiff's employee who has been responsible for the theft occuring.

CONCLUSION

The decision of the Court below should be reversed on the grounds that its findings of fact were clearly erroneous in finding that the Bank acted in good faith in failing to determine where Mazzochi obtained $212,000 in Treasury Notes in light of highly suspicious circumstances and Merrill Lynch had no duty to determine the circumstances under which it was purchasing these treasury notes. The plaintiff is entitled to recover its monies from the defendants for the role they played in the conversion of the plaintiff's treasury notes.

Respectfully submitted,

Julien & Schlesinger, P.C.

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AFFIDAVIT OF SERVICE

Re: 76-7067
U.S. Fidelity & Guaranty Co.
v. Royal Natl Bank of NY et al

STATE OF NEW JERSEY :
: ss.:
COUNTY OF MIDDLESEX :

I, Muriel Mayer , being duly sworn according to law, and being over the age of 21 upon my oath depose and say that: I am retained by the attorney for the above named Plaintiff-Appellant .

That on the 23rd day of August , 1976, I served the within Reply Brief for Plaintiff-App. in the matter of U.S. Fidelity & Guaranty Co. v. Royal National Bank of N.Y. & Merrill Lynch, Pierce, Fenner & Smith upon Konheim, Halpern & Bleiwas, Esqs., 11 Park Place, NY, NY 10007 and Hart & Hume, Esqs., 10 East 40th St. New York, NY 10016

by depositing two (2) true copies of the same securely enclosed in a post-paid wrapper, in an official depository maintained by the United States Government.

Muriel Mayer
Muriel Mayer

Sworn to and subscribed before me this 23rd day of August 1976.

Lorraine Leotta
A Notary Public of the State of New Jersey.

LORRAINE LEOTTA
NOTARY PUBLIC OF NEW JERSEY
My Commission Expires April 13, 1977